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Incorporated in 1992, the National Association of Consumer Bankruptcy Attorneys ("NACBA") is a non-profit organization of more than 500 consumer bankruptcy attorneys nationwide. Member attorneys and their law firms represent debtors in an estimated 100,000 bankruptcy cases filed each year. NACBA's corporate purposes include education of the bankruptcy bar and the community at large on the uses and misuses of the consumer bankruptcy process. Additionally, NACBA advocates nationally on issues which can not adequately be addressed by individual member attorneys. NACBA is the only national association of attorneys organized for the specific purpose of protecting the rights of consumer bankruptcy debtors.

The NACBA membership has a vital interest in the outcome of this appeal. NACBA members primarily represent individual low- and moderate-income wage-earners. Most of the cases arising under 11 U.S.C. § 523(a)(2)(A), the provision at issue in this case, are cases brought by corporate creditors against these individual consumer debtors for alleged fraud in

connection with obtaining consumer credit. A requirement of "reasonable reliance" in the elements of proof under § 523(a)(2)(A) is essential to prevent sophisticated corporate creditors from asserting meritless claims of fraud against comparatively unsophisticated debtors.

Additionally, NACBA membership is gravely concerned about creditor misuse of the economic leverage which a meritless claim of fraud can create in a consumer bankruptcy case. Since most consumer debtors are in the throes of financial difficulties, they face a significant financial hardship in defending an action asserting nondischargeability. Many debtors therefore default or consent to relief in dischargeability litigation. Creating a standard of proof for fraud which does not include reasonable reliance, despite the overwhelming consensus in the common law in favor of some form of objective requirement, would undoubtedly create additional cases in which creditors pursue nondischargeability litigation in the bankruptcy process for economic leverage alone.

This brief will present material which may not otherwise be available to the Court. NACBA members are concerned that since the debtor/respondent was not represented by an attorney in the courts below, he may not have developed the full range of arguments which would support the debtor position.

To a large extent, the case before the court is anomalous because it involves relatively unsophisticated individual creditors asserting fraud against another individual. NACBA members see the far more common use of the same provision by corporate creditors and have an interest in making the court aware of that context for the issues present in this case.

SUMMARY OF ARGUMENT

Affirmance of the First Circuit Court of Appeals is mandated by this court's prior decision in Grogan v. Garner, 498 U.S. 279 (1991) and the common law elements required to prove a cause of action for fraud. Since neither the plain language of the statute, nor the legislative history makes clear Congress' intentions concerning the elements of fraud under 11 U.S.C. § 523(a)(2)(A), the Court, as in Grogan, must interpret

the meaning of Congressional silence. The elements of fraud at common law unquestionably and overwhelmingly include an objective standard for reliance. If Congress had intended a different standard for proof of fraud when that cause of action is incorporated by reference in the Bankruptcy Code, it would have said so.

Although there are a variety of formulations of the common law objective standard for proof of reliance including "reasonable reliance", "justifiable reliance", and "the right to rely", each formulation is directed at establishing that there is a genuine causal connection between the statement made and the injured party's course of action. If this Court eliminates an objective standard for proof of fraud from section 523(a)(2)(A), bankruptcy court would be the only forum where reliance is evaluated entirely subjectively. The bankruptcy process would therefore become a disadvantage to some debtors.

The petitioners' main argument is logically untenable. The inclusion of the term "reasonably relied" in section 523(a)(2)(B), taken together with the absence of that language in

section 523(a)(2)(A), cannot express Congressional intent that reasonable reliance is to be excluded as an element for proof of fraud in cases under section 523(a)(2)(A). Section 523(a)(2)(A) applies to " ... false pretenses, a false representation or actual fraud ..." without an enumeration of the elements of those common law claims. Section 523(a)(2)(B), on the other hand, enumerates the elements of a statutory creation of the Bankruptcy Code. It includes not only an express reasonable reliance requirement, but also a <u>materiality</u> requirement and an <u>intent</u> requirement among others. What the petitioners miss is that the same analysis could equally well be applied to <u>materiality</u> and <u>intent</u> since these are expressly mentioned in section (a)(2)(B), but not (a)(2)(A). The petitioners' analysis would create a standard for proof of fraud not only without reasonable reliance, but also without materiality and without intent to deceive.

An objective standard for proof of reliance is also consistent with policy considerations. While bankruptcy relief is intended for the honest debtor, the common law ultimately

does not punish statements on which no party should reasonably rely. This protects against blind reliance on the category of misstatements which a reasonable person would ignore and helps prevent claims of fraud by plaintiffs who did not actually change their course of action based on the purportedly false representation. The objective standard thus protects honest debtors from creditors making unsupported claims of fraud.

Additionally, as the Court noted in Grogan, bankruptcy administration is facilitated by use of a standard for proof of fraud in bankruptcy which is as consistent as possible with the standard used under the common law in other courts. Consistent standards maximize the opportunities for collateral estoppel.

Finally, reasonable reliance for proof of fraud is required to protect the honest debtor from the dishonest creditor. Creditors should not be permitted to use the economic leverage of a dischargeability complaint (and the costs of its defense) unless they can prove that fraud was committed under

a standard which would be cognizable in courts outside the bankruptcy process.

ARGUMENT

I. THE ELEMENTS REQUIRED TO ESTABLISH FRAUD CANNOT BE DETERMINED BASED ON THE LANGUAGE OF THE BANKRUPTCY CODE OR THE LEGISLATIVE HISTORY; NEITHER SOURCE PROVIDES ANY BASIS ON WHICH TO DETERMINE WHETHER REASONABLE RELIANCE IS REQUIRED AS AN ELEMENT OF FRAUD FOR THE PURPOSES OF THE BANKRUPTCY CODE.

A. The terms, "false pretenses, a false representation, or actual fraud," do not have a plain meaning independent of their common law elements.

The first principle of statutory construction is "that statutory interpretation begins with the language of the statute itself." Pennsylvania Dept. of Public Welfare v. Davenport, 495 U.S. 552, 557-58 (1990) citing Landreth Timber Co. v. Landreth, 471 U.S. 681, 685 (1985). However, in this case, the plain language does not elucidate the meaning of the statute on the question before the Court. Congress' use of the terms "false pretenses", "false representation", and "fraud" provides

no guide to the elements which Congress intended as the requisites for proof of those claims.

The mere omission of the words "reasonable reliance" from subsection (A) does not indicate that Congress intended to eliminate the reasonable reliance element of common law fraud from subsection (A) claims.[1] Section 523(a)(2) contains no language that supports petitioners' assertions to the contrary.

The formulation of subsection (A) is inherently different from that of subsection (B). Subsection (B) describes a

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[1] **Section 523(a)(2) provides in pertinent part that a debtor is not entitled to be discharged from any debt to the extent that the debt was obtained by:**

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing--
(i) that is materially false;
(ii) respecting the debtor's or an insider's financial position
(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
(iv) that the debtor caused to be made or published with intent to deceive;

*** * ***

statutorily defined claim which expressly enumerates elements because there is no common law correlate limited to false statements in writing. By contrast, subsection (A) incorporates by reference causes of action at common law. Elements must be supplied to give effect to the subsection (A) claims.

As the court recognized in Grogan v. Garner, 498 U.S. 279, 286 (1991), in a related context, Congressional silence suggests that Congress did not intend an unusual standard for proof of fraud which departs from the legal norm. Well defined common law standards thus become the natural source for identifying the appropriate elements of proof.

As discussed more fully below in Section II, a requirement of reasonable reliance is indisputably an element of proof of fraud at common law. Congress incorporated reasonable reliance *and other common law* elements of fraud into its formulation of subsection (B). There is no logic to petitioners' position that use of common law terms in subsection (B) in defining a claim which amounts to a type of fraud, is evidence that Congress did not intend to include similar

common law elements when referencing "actual fraud" in subsection (A). If anything, Congress' awareness of the common law standard for fraud in formulating subsection (B) suggests that Congress intended incorporation of those elements when it referenced the common law claim directly.

B. The legislative history provides no guide to Congressional intent behind the statutory language on the question of whether proof of fraud requires proof of reasonable reliance.

1. There is no support in the legislative history for petitioners' position; Congress was entirely silent with regard to reasonable reliance under 11 U.S.C. § 523(a)(2)(A)

It is appropriate to turn next to the legislative history as a guide to Congressional intent. See Dewsnup v. Timm, 502 U.S. 401 (1992).

Despite petitioners' attempts to imply content from a sketchy legislative record, on careful reading the record is entirely silent as to the elements required to establish the claims referenced in subsection (A). Although there are two references to "reasonable reliance" in the record and both apply to Subsection (B), neither reference is made in a context which

limits the elements of the common law causes of action included in subsection (A).

The first reference to reasonable reliance is expressly limited to "a false statement in writing" and is applicable only to subsection (B).[2] This immediately follows a related statement that "actual fraud is added as a grounds for exception from discharge". The elements of the "actual fraud" claim are nowhere described or otherwise limited.

Contrary to petitioners' position, it is impossible to draw any conclusion about the subsequent reference in the record to codifying "case law", because that statement is logically attached only to the previous sentence on "false statements in writing". The reference to existing "case law" could not potentially relate to the term "actual fraud", because

[2] "This provision is modified only slightly from current section 17(a)(2). First, "actual fraud" is added as a grounds for exception from discharge. Second, the creditor must not only have relied on a false statement in writing, the reliance must have been reasonable. This codifies case law construing this provision. Third, the phrase "in any manner whatsoever" that appears in current law after "made or published" is deleted as unnecessary. The word "published" is used in the same sense that it is in slander actions." H.R. Rep. No. 595, 95th Cong., 1st Sess. 364 (1977); S.Rep. No. 989, 95th Cong. 2d Sess. (1978).

that term was being added to the Code in 1978. Prior case law could not have addressed the elements of a newly created exception to dischargeability.

The second legislative reference acknowledges that "[t]he courts have recently begun to require that the reliance be reasonable." H.R. Rep. No. 595, 95th Cong., 1st Sess. 130 (1977). That statement is contained entirely within a discussion of false statements in writing and cannot logically be interpreted expressly or impliedly to limit the elements of claims under other subsections. Again, what courts had or had not previously required could have no bearing, by implication or otherwise, on a newly created provision of the Code.

Petitioners and their amicus stretch mightily to give content to the legislative history by suggesting that Congressional discussion of reasonable reliance as an element under subsection (B), without a comparable discussion about reasonable reliance under subsection (A), is an indication of an intent to exclude that element of fraud under subsection (A). The proposed negative inference, however, is undermined by

the complete absence of any discussion of the elements of claims under subsection (A). Congress was not undertaking a comparative analysis. The claims referenced in subsection (A) cannot be given content without reference to their common law elements.[3]

"If anything, the legislative history suggests that Congress believed it was codifying case law under § 17a(2) requiring reasonable reliance." In re Paolino, 89 B.R. 453, 462 (Bankr.E.D.Pa. 1988). Given the state of the common law of

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[3] The amicus supporting petitioner's position asserts that if an objective standard of reliance is included as an element of fraud under section (A), then there would be no reason for the existence of section (B). That is not the case. The term "fraud", without more, is a reference to a claim at common law with the variety of elements and interpretations which the common law, by its nature, establishes. By delineating elements under section (B), Congress gave content to a claim independent of the common law.

This case represents a good example of the distinction between these two methods of drafting and suggests the reasons why Congress used both methods in the same section. Fraud at common law includes an objective standard which is enunciated by a variety of courts in a variety of ways. That requirement evolves with the common law. Where "fraud" is incorporated by reference in the Code, collateral estoppel from a variety of jurisdictions with a variety of formulations for fraud is possible. On the other hand, elements of the claim in section (B) are fixed by Congress so that no alternative standard is possible. Congress was obviously concerned about lower standards for proof of fraud being applied in some Courts.

fraud and its inclusion of an element requiring reasonable reliance at the time of Congress' enactment of the Bankruptcy Code, Congress would have had to denounce this case law expressly if it intended for it to be legislatively overruled. See Kelly v. Robinson, 479 U.S. 36, 47 (1986), citing Midlantic National Bank v. New Jersey Dept. of Environmental Protection, 474 U.S. 494 (1986). The legislative record provides no indication that Congress wanted to eliminate the reasonable reliance requirement for bankruptcy dischargeability actions based in fraud.[4]

2. There was no clear position on this issue in pre-Code case law which Congress was codifying in drafting section 523(a)(2)(A).

The question before the court cannot be decided based on Congress' inferred knowledge of pre-code case law. See Kelly v. Robinson, supra at 47. There was no clear position on the question of whether reasonable reliance was required as an

[4] The legislative history taken as a whole indicates a strong Congressional intention to enhance the discharge provision rather than to cut it back. See generally, H.R. No. 95-595, p. 128 (1977). It is inconsistent with an enhanced discharge to provide for nondischargeability for fraud without reasonable reliance.

element of proof of fraud for dischargeability purposes, except in cases involving false statements in writing.

Prior to 1979, decisions generally did not provide enough information to establish whether the courts would have required reasonable reliance in a cause of action for fraud. The predecessor statute, Bankruptcy Act § 17(a)(2), was not divided into two parts, although the majority of reported pre-code cases are § 523(a)(2)(B) type cases because they involved allegations of a false statement in writing. E.g., In re Taylor, 514 F.2d 1370, 1372-73 (9th Cir. 1975); In re Adams, 368 F. Supp. 80, 81 (D. S.D., 1973); In re Dolnick, 374 F.Supp. 84, 90 (N.D. Ill., 1974).

The petitioners rely on a 9th Circuit decision from 1978 as an example of a pre-code case which did not require the creditor's reliance to be reasonable. In re Houtman, 568 F.2d 651, 655 (9th Cir. 1978). This case exposes the weakness of petitioners' argument on this point. Most importantly, the House Reports documenting the congressional record are dated 1977 and Houtman was decided on January 25, 1978. Congress could

not possibly have been aware of the Houtman decision in evaluating the proposed language of section 523(a)(2).[5]

Moreover, Houtman merely lists the requirements for proof of fraud as taken from Taylor, supra at 1373. The Taylor case, in turn, involved a false statement in writing. Neither Taylor nor Houtman discusses the issue before the court today. In fact, a later case has interpreted Houtman as requiring reasonable reliance. Carini v. Matera, 592 F.2d 378, 380-81 (7th Cir. 1979). The same Circuit Court which had decided Houtman later required proof of justifiable reliance, despite Houtman, in a case involving fraud under section 523(a)(2)(A). In Re Kirsh, 973 F.2d 1454 (9th Cir. 1992). Regardless, Houtman was not a pre-Code statement of the standard for proof of fraud on which Congress could have relied on in codifying section 523(a)(2).

[5] Congress was presumably equally unaware of post-enactment cases which *do* require reasonable reliance as a prerequisite to proof of fraud in bankruptcy. See Carini v. Matera, 592 F.2d 378, 380-81 (7th Cir. 1979).

In general, the cases which consider the issue do require reasonable reliance for proof of fraud under pre-Code law. See Matter of Garman, 625 F.2d 755, 759 (7th Cir. 1980) (list of citations).[6] However, since 17a(2) was not divided into subsections and since "actual fraud" was first added to the Code in 1978, it is difficult to divine the effect of this case law on Congressional thinking in drafting the Code.

The reference to case law on the reliance requirement in the legislative history is an acknowledgement that courts were beginning to require "that the reliance be reasonable." H.R. Rep. No. 595, 95th Cong., 1st Sess. 130 (1977). If anything, this supports the position that Congress was aware of the common law basis for this emerging case law. Given Congressional silence on the issue of reasonable reliance in proof of "actual fraud", it makes little sense to assume that Congress was unaware of the impact of this case law in the

[6] A case decided by this Court which discusses pre-Code law on these issues does not meaningfully address the question of reasonable reliance. In that case reliance appears to have been assumed. Morimura, Arai, & Co. v. Taback, 279 U.S. 24 (1928).

context of section 523(a)(2)(A) where it chose not to codify specific elements to establish proof of fraud.

C. The Circuit Court in Ophaug incorrectly concluded that by including a requirement of reasonable reliance in section 523(a)(2)(B), Congress was, by implication, excluding that requirement from section 523(a)(2)(A).

The 8th Circuit Court of Appeals erroneously concluded that under § 523(a)(2)(A) creditors were not required to act reasonably when relying on misrepresentations made by consumers seeking credit. In re Ophaug, 827 F.2d 340, 341 (1987).

The Ophaug Court erred in finding the statute to be clear on its face. As discussed above, the language of § 523(a)(2) is not specific enough to determine congressional intent. In its plain language argument, the Ophaug Court asserts that the inclusion of a requirement of reasonable reliance in subsection (B) together with its omission in subsection (A) was intended by Congress to exclude the reasonable reliance element of common law fraud from all claims under subsection (A).

Use of this line of argument for analysis of § 523(a)(2) is inherently flawed. As discussed above, subsection (B) sets out elements of a statutorily created claim, while subsection (A) merely references common law causes of action. Subsection (B) thus expressly includes a requirement of materiality and a requirement of "intent to deceive" in addition to the requirement of reasonable reliance. These same elements are not included in subsection (A). Following this logic of the Ophaug court, one would have to assume that Congress intended to eliminate the materiality and intent elements of common law fraud from subsection (A) since they are incorporated in subsection (B), but not in (A). This would leave a cause of action for fraud under subsection (A) essentially without elements of proof-- a result which is obviously contrary to the intent of Congress. As discussed below in Section II, common law is the only reasonable means of determining the standard of reliance required under § 523(a)(2)(A).

Further, the Ophaug Court erred in asserting that the reasonableness requirement was an additional burden placed on

§ 523(a)(2)(B) creditors. Ophaug, at 343. Since no similar express provision was added to subsection (A), the court concluded that Congress omitted the requirement so as not to "give additional support to debtors by imposing a reasonableness requirement in §523(a)(2)(A)." Ophaug, at 343, citing In re Fosco, 14 B.R. 918, 922 (Bankr. D. Conn. 1981). This argument is flawed in that there was no additional requirement being imposed by Congress specifically for subsection (B). The legislative record with respect to the reasonable reliance requirement is clear; Congress intended to "codif[y] the [existing] case law construing this provision." H.R. Rep. No. 595, 95th Cong., 1st Sess. 364 (1977).

II. THE DETERMINATION OF THE LEGAL PREREQUISITES FOR PROOF OF FRAUD MUST BE TAKEN FROM THE COMMON LAW; THE COMMON LAW INCLUDES REASONABLE RELIANCE AS AN ELEMENT OF PROOF OF FRAUD

A. In the absence of Congressional guidance, terms originating in the common law such as fraud, false pretenses and false representation can only be defined by reference to the common law.

In a recent case, this Court evaluated the appropriate standard of proof for dischargeability cases based on fraud and concluded that because Congress was silent on the question, the more generally applicable preponderance of the evidence standard should apply. Grogan v. Garner, 498 U.S. 279, 286 (1991). Grogan is based on the principle that, where the language of the statute does not prescribe a standard and the legislative history is silent, the Court cannot imply that Congress intended a standard of proof which differs from the norm. Id. at 286.

The issues before the Court here are similar. As discussed immediately below in Subsection B.1., virtually every state jurisdiction and the leading commentators agree that the common law standard for proof of fraud requires proof of reasonable or justifiable reliance. This objective standard allows the fact finder to apply a test which fairly evaluates whether there is a genuine causal relationship between the alleged false statement and the complainants' course of conduct in reliance. Since Congress was entirely silent about the

elements under section 523(a)(2)(A), the Court should not imply that Congress intended a novel standard for proof of fraud to be applied.

Similarly, a requirement of reasonable reliance "reflects a fair balance between . . . conflicting interests." Grogan, at 287. As in Grogan, to assert that Congress intended a special standard of proof would be to assume that it intended to tip the established balance for proof of fraud in favor of one party over another. It is not reasonable to conclude that "Congress silently endorsed a background rule," to apply a special standard of proof. Grogan, at 290. After Grogan, the only appropriate method for determining the applicable elements of proof of fraud under §523(a)(2)(A) is to apply the normal legal elements of proof of fraud as developed in the common law.

B. The common law requires an objective standard for the requisite reliance to establish fraud; this is most often termed "reasonable reliance."

1. Although it is expressed in a variety of ways, an objective standard for reliance has long been part of the common law for proof of fraud.

The restatements, treatises, and the case law all conclude that an objective standard for reliance is required to establish fraud. These sources of primary and secondary law use various terms to state the principle that reliance alone is insufficient to establish fraud, but their conclusion is the same: "the reasonableness of a creditor's reliance will be evaluated according to the particular facts and circumstances present in a given case." In re Mullet, 817 F.2d 677, 679 (10th Cir. 1987).

The common law rule is that "the recipient must not only in fact rely upon the misrepresentation, but his reliance must be justifiable." Restatement (Second) of Torts § 537 cmt. b, (1978). *See also*, W. Page Keeton et al., Prosser and Keeton on the Law of Torts § 108, at 749 (5th ed. 1984) ("Not only must there be reliance but the reliance must be justifiable under the circumstances.").

This general rule is now followed universally for proof of fraud in state courts. A sampling of relatively recent case law is instructive. Some courts call the relevant standard

"reasonable reliance".[7] Others refer to a "justifiable reliance".[8] Still other courts refer to a "right to so

[7] Synergistic Technologies, Inc. v. IDB Mobile Communications, Inc., 871 F.Supp. 24 (D.D.C. 1994); Sazerac Co., Inc. v. Falk, 861 F.Supp. 253 (S.D.N.Y. 1994); Peach State Meat Co. v. Excel Corp., 860 F.Supp. 849 (M.D.Ga. 1994); DeBry v. Noble, 889 P.2d 428 (Utah 1995); R.R.S. II Enterprises Inc. v. Regency Associates, 646 N.E.2d 56 (Ind.App. 4 Dist. 1995). See also, e.g., American Safety Equipment Corp. v. Winkler, 640 P.2d 216, 224 (Colo. 1982); Lock v. Schreppler, 426 A.2d 856, 863 (Del.Super 1981); Stewart Title of Idaho, Inc. v. Nampa Land Title Co., Inc., 715 P.2d 1000, 1002 (Idaho 1986); Bernan v. Gurwicz, 189 N.J.Super. 89 (1981); Sippy v. Cristich, 4 Kan.App. 2d 511 (Kan. 1980); Southern States Ford, Inc. v. Proctor, 541 So.2d 1081, 1092 (Ala. 1989); Radford v. J.J.B. Enterprises, Ltd., 163 Wis.2d 534 (Wis.App. 1991); Sugarline Associates v. Alpen Associates, 155 Vt. 437 (Vt. 1980).

[8] E.g., In re Harris Pine Mills, 44 F.3d 1431 (9th Cir. 1995) (Oregon law); Bank of the West v. Valley Nat. Bank of Arizona, 41 F.3d 471 (9th Cir. 1994) (California law); Sudul v. Computer Outsourcing Services, 868 F.Supp. 59 (S.D.N.Y. 1994); Mulgrew v. Sears Roebuck & Co., 868 F.Supp. 98 (E.D.Pa. 1994); Chimento Co., Inc. v. Banco Popular de Puerto Rico, 617 N.Y.S.2d 157 (A.D. 1 Dept. 1994); Perez Trucking, Inc. v. Ryder Truyck Rental, Inc., 886 P.2d 196 (Wash.App.Div.3 1994); Eckholt v. American Business Information, Inc., 873 F.Supp 510 (D.Kan. 1994); Masters v. San Bernardino County Employees Retirement Ass'n, 37 Cal.Rptr.2d 860 (Cal.App. 4 Dist. 1995); Thor Bear, Inc. v. Crocker Mizner Park, Inc, 648 So.2d 168 (Fla.App. 4 Dist. 1994); Maddox v. Southern Engineering Co., 453 S.E.2d 70 (Ga.App. 1994); McGough v. Gabus, 526 N.W.2d 328 (Iowa 1995).

rely".[9] This last standard is indistinguishable from justifiable reliance in its application. E.g., Hereford v. Unknown Heirs, 315 S.W. 2d 412, 421 (Mo. 1958) (right to rely equated with justifiable reliance).

The rationale for these decisions is to provide some objective way to measure actual reliance and to prevent fraud claimants from asserting that they altered their course of conduct based on a statement and a set of circumstances which do not objectively suggest that they were actually misled. A reasonable reliance requirement provides "some objective corroboration that [the claimant] did rely". Prosser at § 108, 749-750.

Similarly, most of the Circuit Courts which have considered the issue have made some form of objective reliance requirement an element of fraud for the purpose of

[9] Elsberry v. Boulevard Motors, Inc., 886 S.W.2d 732 (Mo.App.E.D. 1994); Cottonhill Inv. Co. v. Boatmen's Nat. Bank of Cape Girardeau, 887 S.W.2d 742 (Mo.App. S.D. 1994); Hansen v. DHL Laboratories, Inc., 450 S.E.2d 624 (S.C.App. 1994).

nondischargeability in bankruptcy.[10] Even the petitioners' brief, which lists a number of decisions for and against a reasonable reliance requirement, supports an assertion that the majority of case law dictates an objective standard of reliance. Petitioners' Brief at 14-15, n.5-6. The requirement of reasonable or justifiable reliance for the purpose of proof of fraud serves the same purpose in bankruptcy as it does outside bankruptcy. See, e.g., Matter of Garman, 625 F.2d 755, 759 (7th Cir. 1980) ("reasonableness is circumstantial evidence of actual reliance").[11]

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[10] Commerce Bank & Trust Co. v. Burgess, 955 F.2d 134, 140 (1st Cir. 1991); In re Ledford, 970 F.2d 1556, 1559 (6th Cir. 1992); In re Kimzey, 761 F.2d 421, 423 (7th Cir. 1985); Carini v. Matera, 592 F.2d 378, 380-81 (7th Cir. 1979); In re Kirsh, 973 F.2d 1454, 1457-58 (9th Cir. 1992); In re Mullet, 817 F.2d 677, 679 (10th Cir. 1987). In re Hunter, 780 F.2d 1577, 1579 (11th Cir. 1986).

[11] One question which is presented to some extent by the facts of this case is whether a reasonable reliance requirement may include a duty to investigate. The Seventh Circuit Court of Appeals, which had previously required reasonable reliance as an element of fraud, recently concluded that such a requirement does not generally include a duty to conduct a thorough investigation. Matter of Mayer, 51 F.3rd 670 (7th Cir. 1995). That conclusion is consistent with the common law which generally does not include a duty to investigate except to the extent that failure to investigate

(continued...)

Additionally, New Hampshire, the state in which this case originated, requires a reasonable reliance standard for proof of common law fraud. "In order to prove deceit, the plaintiff must prove that the defendant intentionally made material false statements to the plaintiff, which the defendant knew to be false or which he had no knowledge or belief were true, for the purpose of causing, and which does cause, the plaintiff *reasonably* to rely to his detriment." Caledonia, Inc. v. Trainor, 123 N.H. 116, 459 A.2d 613 (1983).

2. The appropriate objective standard can best be expressed through a requirement framed as "reasonable reliance."

Reasonableness is an objective standard of behavior which compares the actions of the creditor to a that of a reasonable person. Although courts use a variety of terms for

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[11](...continued)

represents a deliberate closing of one's eyes to the actual facts. See Prosser, supra. The Court need not decide the question of the extent of an appropriate investigation, but may rather express the view consistent with the commentators that reasonableness should be considered in light of the circumstances, the available information and the relationship of the parties. In certain situations, a fact finder may conclude that the circumstances would trigger a reasonable person to investigate.

this objective standard, the common aim is to determine whether reliance was appropriate given the circumstances of the transaction. Compare, e.g., In re Kirsh, 973 F.2d 1454 (9th Cir. 1992) (requirement of "justifiable reliance" is one which takes into account the knowledge and relationship of the parties) with In re Mullet, 817 F.2d 677, 679 (10th Cir. 1987) ("the reasonableness of a creditor's reliance will be evaluated according to the particular facts and circumstances present in a given case.") As the Ninth Circuit noted in Kirsh, "[t]his use of the word 'reasonable' in place of 'justifiable' is of no real moment unless a later reader is led away from the true content of the reliance element. Kirsh, supra at 1459.

Nevertheless, use of the term "reasonable" appears to represent the more common articulation of the standard. It is also the term chosen by Congress in setting out elements (obviously derived from common law) for a statutory cause of action for fraud based on a false financial statement. Since "reasonable" and "justifiable" reliance are virtually interchangeable in the common law, there is no good reason in

bankruptcy to create confusion by articulating one standard under section 523(a)(2)(A) and another under section 523(a)(2)(B).

3. Petitioners' position leads to an illogical result which is contrary to hundreds of years of development of the common law of fraud.

Reasonable reliance is a tool for the finder of fact. A requirement of reasonable reliance provides a gauge for measuring both materiality of the misrepresentation and actual reliance, two elements of common law fraud.

Where reliance is found to be reasonable in the circumstances, then the materiality element must also be satisfied. "Reliance upon a fraudulent misrepresentation is not justifiable unless the matter misrepresented is material." Restatement (Second) of Torts § 538(1) (1976). Likewise, where reliance is reasonable, it is much more likely that actual reliance does in fact exist. "If plaintiff can claim reliance on the basis of the kind of statement on which no reasonable person would rely for one reason or another, then it is quite likely that plaintiff did not rely." W. Page Keeton et al.,

Prosser and Keeton on the Law of Torts §108, at 750 (5th ed. 1984).

If petitioners' position is adopted, it would lead to the absurd result that fraud based on a writing would be harder to establish than fraud based on an oral statement. Where there is a writing, there is direct evidence of the claimed misrepresentation which can contribute to a fact finder's conclusions about the impact of that misstatement on the party asserting fraud. Absent the writing, fraud is harder to pin down and the tool of evaluating the reasonableness of reliance has additional uses. Eliminating reasonable reliance from evaluation of fraud based on oral statements would inappropriately undermine the process which the common law has created to find the truth.

III. A "REASONABLE RELIANCE" REQUIREMENT UNDER SECTION 523(a)(2)(A) IS CONSISTENT WITH A VARIETY OF BANKRUPTCY POLICIES, AND CREATES EFFICIENCY FOR THE ADMINISTRATION OF JUSTICE.

A. Use of a common law standard for fraud including reasonable reliance increases the potential

for cases to be resolved based on collateral estoppel because the same standard will be used in state and federal courts.

The use of a reasonable reliance standard in common law proof of fraud is so pervasive as to be nearly universal. By incorporating it into bankruptcy law proof of fraud under § 523(a)(2)(A), opportunities for collateral estoppel will be enhanced when dischargeability claims are tried, but the underlying claims are not ultimately liquidated in the bankruptcy process.

The Court in Grogan recognized the value to the judicial system of creating a common standard for proof of fraud so that claims litigated in one forum can be established by collateral estoppel in another. Grogan, supra, at 284-285. The Grogan case presented one paradigm, that is a claim liquidated under a particular evidentiary standard outside bankruptcy, where collateral estoppel is sought in a later bankruptcy action to determine dischargeability of the debt. Id. at 281-282.

This case presents a different paradigm; that is the debt is unliquidated at the time of bankruptcy, its dischargeability

can be decided in bankruptcy, but the parties may have to return to state court in order to liquidate the amount of the claim. Under this paradigm, it makes little sense to have a bankruptcy court evaluate whether a debt is nondischargeable, based on evidence which may not ultimately establish that there is a debt at all in state court. See In re Paolino, 89 B.R. 453, 462 (Bankr. E. D. Pa. 1988). If the state law standard and the bankruptcy standard are the same, the bankruptcy nondischargeability judgment would establish liability in the later state court case by collateral estoppel.

Furthermore, unlike the situation in Grogan, a rule which requires reasonable reliance for proof of fraud would not be at variance with the law of other jurisdictions. It would therefore not preclude application of collateral estoppel in bankruptcy to state court judgments based on fraud.

Particularly, as here, where the law requiring an objective standard for proof of reliance is pervasive in nonbankruptcy courts, no useful purpose can be served by

establishing a different standard in the federal bankruptcy system.

B. A reasonable reliance requirement is consistent with the principle that exceptions to dischargeability be narrowly construed; a principle which Congress understood was in place when it passed the Bankruptcy Code.

It is well established precedent that exceptions to discharge be narrowly construed. Gleason v. Thaw, 236 U.S. 558 (1915). See also, In re Leichter, 197 F.2d 955 (3rd Cir. 1952). That principle is consistent with the importance of the discharge available under the Bankruptcy Code and the policies which support it. Local Loan Co. v. Hunt, 292 U.S. 234 (1934). These principles had been so long held at the time of the passage of the Bankruptcy Code, that Congress must be held to have been fully aware of them when the new law was passed in 1978. Kelly v. Robinson, 479 U.S. 36, 47 (1986). In addition, Congress was unequivocal about the importance of the discharge. See also H.R. No. 95-595, p. 128 (1977) ("Perhaps the most important element of the fresh start for a consumer debtor after bankruptcy is discharge. ... H.R. 8200 proposes to

remedy the deficiencies in the current discharge provisions and to make the discharge effective relief for consumer debtors.")

A statutory construction which obligates debtors for nondischargeable claims on proof which would be insufficient to establish that same claim in state court would be entirely inconsistent with narrow construction of exceptions to discharge and with Congressional intent to enhance the discharge. In fact, for some debtors, bankruptcy and the relief it is intended to offer would actually become a disadvantage. That is because they might be found liable absent reasonable reliance by their creditor, even though that creditor could not establish a debt based on fraud in a nonbankruptcy court.

C. A reasonable reliance requirement will discourage frivolous and/or dishonest claims of fraud by creditors and will reduce claims by issuers of consumer credit based on debtor conduct which had nothing to do with the reasons credit was granted.

As discussed above, the purpose of a reasonable reliance requirement, as it has developed in the common law, is to help identify legitimate claims in which the complainant was actually relying on a material misstatement of a relevant fact. Over

time, the common law has developed a principle which prevents fraud plaintiffs from asserting that they were harmed by statements which, in the circumstances, they did not accept or should not have accepted at face value.

The case before the Court presents the unusual situation in which the plaintiffs in a nondischargeability proceeding are individuals. The vast majority of nondischargeability claims in the bankruptcy process are raised by large corporate creditors against individual debtors.[12] Most claims involve consumer credit issued by relatively sophisticated corporate entities. The corporate creditor has a significant financial advantage in dischargeability litigation, since consumer bankruptcy debtors, because of their financial circumstances, are frequently unable to afford counsel to litigate on their behalf.[13]

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[12] The defendant in a nondischargeability action under 11 U.S.C. § 523(a) is always an individual. That section only applies to individual debtors.

[13] 11 U.S.C. § 523(d), a fee shifting provision applicable to some cases, only partially addresses creditor overreaching, since in order to take advantage of it, a debtor must pay the up front costs of litigation and prevail on grounds which establish that the creditor's position was not substantially justified. Many consumer (continued...)

Elements of proof of fraud which are less rigorous than the common law standard will inappropriately enhance the creditor advantage in the bankruptcy dischargeability litigation process. This is particularly true because sophisticated corporate creditors would be permitted to prevail in a dischargeability action even absent some objective indicia of reliance on the statements of an unsophisticated consumer debtor.

Some creditors already file multiple standard form nondischargeability actions in order to gain the economic leverage which is created by forcing the debtor to litigate an expensive claim. Reducing the standards which most courts currently apply to those cases will undoubtedly increase their number.

Additionally, several credit card issuers freely dispense credit cards with no review at all of the creditworthiness or

[13](...continued)
debtors default or agree to relief in cases brought by unreasonable creditors because they cannot afford the up front costs of the litigation.

financial circumstances of the persons to whom the credit is issued. These creditors make a business decision not to reasonably rely on representations made by the persons to whom they issue credit, but rather expect to profit by high rates of interest spread over a large pool of borrowers. A decision in favor of petitioners' position would encourage these creditors because there would be no need in bankruptcy to establish meaningful reliance on any implied or oral statements made in the credit transaction. See generally In re Cox, 1995 WL 349089 (Bankr. D. Mass. 1995) (evaluating whether there is the requisite degree of reliance in the context of a debtor's use of a credit card).

D. A reasonable reliance requirement will not create a safe haven in bankruptcy for dishonest debtors since fraud cannot be proved anywhere without some type of objective standard applicable to the plaintiff's behavior.

In Grogan, the Court expressed concern that dishonest debtors might take advantage of the Bankruptcy Code to escape from debts which are based on their fraudulent conduct. Grogan, supra at 286-87. Certainly, some of the exceptions to

discharge are designed to protect creditors from debtors who engage in activity which society chooses to condemn.[14]

However, a more subtle question arises in determining when a particular debtor should be identified as dishonest. The common law of fraud has developed in a way which is intended to separate legitimate from illegitimate claims. Ultimately, no one is defined as dishonest by our common law unless the complainant can establish that their reliance on any statements made is reasonable or justifiable in the circumstances of the case. The principle is no less valid in bankruptcy court than in its pervasive common law application.

[14] 11 U.S.C. § 523(a)(2),(4),(6),(9),(12).

CONCLUSION

For all the foregoing reasons, NACBA urges that the decision of the Court of Appeals for the First Circuit in this case be affirmed.

Respectfully Submitted,

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